Tax Update

Provisions of the Final Tax Reform Bill Affecting Nonprofit Tax-Exempt Organizations

December 21, 2017

On December 20, 2017, the Senate and House of Representatives passed H.R. 1, known as the "Tax Cuts and Jobs Act" ("Tax Reform Bill"). President Trump is expected to sign the Tax Reform Bill by early January. The Tax Reform Bill would represent the most significant revision to the tax code in over thirty years. Our summary below highlights the key provisions in the Tax Reform Bill that will impact not-for-profit, tax-exempt organizations. Several other provisions are summarized in our Tax Update, "Fifteen Key Provisions in the Final Tax Reform Bill." Most changes are generally effective as of 2018.

1. Changes to the Excise Tax Regime

1.4% Excise Tax on Investment Income of Private Colleges and Universities

Under current law, public charities are not subject to an excise tax on their net investment income. The Tax Reform Bill imposes a 1.4% excise tax on the net investment income of private colleges and universities that have (i) more than 500 full-time equivalent students, of which more than 50% are located in the United States, and (ii) assets (excluding assets used directly in carrying out the educational institution's exempt purpose) of at least $500,000 per full-time equivalent student.

For purposes of this rule, the assets and net investment income of organizations that are controlled by, or are supporting organizations with respect to, the educational institution are treated as the assets and net investment income of the educational institution. The assets and income of any other related organization are also treated as the assets and net investment income of the educational institution unless they are not intended or available for the use or benefit of the educational institution. However, the assets and net investment income of any related organization will not be taken into account with respect to more than one educational institution. The provision is effective for taxable years beginning after December 31, 2017.

2. Compensation-Related Changes

Excise Tax on Tax-Exempt Organization Executive Compensation

For charitable and religious organizations and public utilities and municipalities, tax-exempt under either section 501(a) or section 115(1) of the Code, the Tax Reform Bill imposes a 21% excise tax on any compensation in excess of $1 million and certain excess "parachute" payments paid to any of an organization's five highest-paid employees (each a "covered employee").[1] The tax is paid by the exempt organization and applies to all remuneration of a covered employee (including non-cash benefits) not subject to a substantial risk of forfeiture, other than payments to tax-qualified retirement plans, amounts that are excludible from the covered employee's gross income, and the portion of any compensation paid to a licensed medical professional (*i.e.*, a doctor, nurse or veterinarian) which is for the performance of medical or veterinary services by the professional. Remuneration also includes amounts paid by related organizations and governmental entities (in which case all organizations pay their pro rata share of the tax). Once an employee qualifies as a covered employee for any year, the excise tax applies to compensation in excess of $1 million and certain parachute payments paid to the person by the organization in any future year.

Because the period to qualify as a covered employee began in tax years beginning in 2017, planning opportunities are limited. The provision attempts to provide parity between the limitation on the deductibility of executive compensation by taxable publicly traded corporations and the treatment of executive compensation paid by tax-exempt organizations.[2] Treasury has authority to prescribe regulations to prevent avoidance of tax, including through performing services other than as an employee or using pass-through or other entities. The provision is effective for taxable years beginning after December 31, 2017.

3. Unrelated Business Income Tax

Fringe Benefit Expenses as Unrelated Business Taxable Income

The Tax Reform Bill subjects tax-exempt organizations to unrelated business income tax ("UBIT") on the value of certain employee fringe benefits, including transportation, parking facilities and on-premises athletic facilities. As with the provision related to executive compensation discussed above, this provision attempts to provide parity between tax-exempt organizations and taxable corporations. This provision is effective for amounts paid or incurred after December 31, 2017.

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[1] The 21% rate is tied to the income tax rate applicable to taxable corporations.

[2] In its summary of the House bill, the Ways and Means Committee Majority Tax Staff questioned whether excessive executive compensation paid by exempt organizations diverts resources from exempt purposes and states that "[g]iven that exemption from Federal income tax constitutes a significant benefit conferred upon tax-exempt organizations, the case for discouraging excess compensation paid out to such organizations' executives may be even stronger than it is for publicly traded companies."

Separate Computation of Unrelated Business Taxable Income

Tax-exempt organizations are generally subject to tax on income from a trade or business that is regularly carried on by the organization and is not substantially related to the performance of the organization's exempt purpose. The Tax Reform Bill requires tax-exempt organizations that carry on more than one unrelated trade or business to separately compute their unrelated business taxable income with respect to each trade or business, meaning that deductions or net operating losses from one business may no longer offset income from another. It is unclear how to interpret "unrelated trade or business" for the purpose of determining unrelated business taxable income (*e.g.*, each investment or an organization's investment portfolio collectively). Although this provision is generally effective for taxable years beginning after December 31, 2017, the Tax Reform Bill provides a transition rule grandfathering pre-existing net operating losses and permitting them to offset future income from any of an organization's unrelated businesses.

4. Changes to Tax-Exempt Bonds

"Advance refunding" bonds are used to refinance debt at lower rates and to pay principal, interest, or the redemption price on a prior bond issue. Advance refunding bonds are issued more than 90 days before the redemption of the prior issue, apply only to governmental and qualified 501(c)(3) bonds, and may be issued once only. The Tax Reform Bill repeals the exclusion from gross income of interest on a bond issued to advance refund another bond. This provision applies to advance refunding bonds issued after December 31, 2017.

Tax credit bonds replace a portion of the interest on bonds with a tax credit, or, in the case of "direct-pay bonds", with a payment of interest from the federal government. These bonds must satisfy certain standards and finance projects in specified areas. The Tax Reform Bill repeals the rules relating to, and prospective authority to issue, tax credit and direct-pay bonds, after December 31, 2017.

5. Other Changes

Charitable Contributions

Under current law, a taxpayer generally may claim a charitable contribution deduction of up to 50% of his or her adjusted gross income ("AGI") for cash and certain property contributed to public charities, private operating foundations, and certain non-operating foundations. A taxpayer may also deduct certain amounts paid to an educational institution for athletic seating event rights, despite receiving a benefit in return for the contribution. For charitable contributions exceeding $250, a donor must obtain a contemporaneous written acknowledge of the contribution from the charity, unless the donee files a return including the applicable information in accordance with Treasury Regulations.

The Tax Reform Bill (i) increases the AGI limitation on cash contributions from 50% to 60%; (ii) denies a charitable deduction for a donation that secures the right to purchase tickets for seating at an athletic event in a stadium at an educational institution; and (iii) repeals the exception to the contemporaneous written acknowledgment requirement for contributions of $250 or more when the donee organization files the required return. The increased charitable deduction is effective for contributions made in taxable years beginning after December 31, 2017 and before December 31, 2026. The repeal of the deduction for amounts paid to secure athletic event seating is effective for contributions made in taxable years beginning after December 31, 2017. The donee substantiation repeal is effective for contributions made in taxable years beginning after December 31, 2016.

Standard Deduction and Estate Tax

Current law allows individual taxpayers to reduce their AGI by either taking a standard deduction or electing to claim itemized deductions. Although the Tax Reform Bill retains the charitable contribution itemized deduction, the Tax Reform Bill also approximately doubles the standard deduction for taxable years beginning after December 31, 2017 and before January 1, 2026, which is expected to reduce the number of taxpayers who itemize their deductions during those years. In addition, the Tax Reform Bill doubles the estate tax exemption for estates of decedents dying after December 31, 2017 and before January 1, 2026. The expansion of the standard deduction and estate tax exemption could have a significant impact on charitable giving.

6. Excluded Provisions

The Tax Reform Bill does not include a number of provisions contained in the House bill that would have affected tax-exempt organizations, described in our November 10, 2017 Tax Update, "Potential Impact of House Tax Reform Bill on Nonprofit Tax-Exempt Organizations," in greater detail.

- Section 501(c)(3) Organizations Permitted to Make Political Statements. The Tax Reform Bill does not modify the "Johnson Amendment," which prohibits all section 501(c)(3) organizations from participating or intervening in political campaigns.

- Private Activity Bonds and Bonds to Finance Professional Sports Stadiums. The Tax Reform Bill does not repeal the tax exemption for interest paid on private activity bonds or bonds used to finance or refinance capital expenditures allocable to professional sports stadiums.

- Scope of Unrelated Business Income Tax Rules. The Tax Reform Bill does not contain a provision that would have "clarified" that all entities exempt from tax under section 501(a) are subject to the UBIT rules, notwithstanding their exemption under any other provision of the Code.

- Simplified 1.4% Private Foundation Excise Tax on Net Investment Income. The Tax Reform Bill does not replace the existing net investment income excise tax regime with a single 1.4% excise tax on private foundations' net investment income.

- Qualified Tuition Reductions and Educational Assistance Programs. The Tax Reform Bill does not repeal the (i) exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations or (ii) exclusion from gross income for certain employer provided educational assistance programs.

- Exception from Private Foundation Excess Business Holding Tax. The Tax Reform Bill does not contain an exception from the private foundation excess business holdings excise tax for certain 100% owned businesses that distribute all of their operating income to the foundation.

- Operational Requirement for Art Museums to Claim Exemption from Excise Tax. The Tax Reform Bill does not require art museums be open to the public for a specified number of hours in order to qualify as an operating foundation.

- Restriction on Exclusion of Research Income. The Tax Reform Bill does not modify the existing research income exclusion from UBIT.

- Donor Advised Fund Reporting Requirements. The Tax Reform Bill does not include additional reporting requirements for donor advised funds.

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